BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of Application of CALIFORNIA-AMERICAN WATER SERVICE COMPANY (U 210 W) for an order authorizing it to increase its rates for water service in its Los Angeles District to increase revenues by $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009	A.06-01-005 (Filed January 9, 2006)

OPENING BRIEF
OF THE DIVISION OF RATEPAYER ADVOCATES

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Commission Decisions

Other Commission Sources

Other Sources

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I. INTRODUCTION

Pursuant to Rule 75 of the Commission's Rules of Practice and Procedure (Rules), the Division of Ratepayer Advocates (DRA) submits this Opening Brief on the General Rate Case Application of California American Water (CAW) for the Los Angeles District for years 2007, 2008, and 2009. CAW seeks an increase in rates of $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009.[1]

On June 23, 2006, CAW and DRA submitted a Proposed Settlement Agreement[2] that covers all aspects of this Application with the exception of (1) CAW's requested Infrastructure System Replacement Surcharge (ISRS) and (2) the appropriate return on equity (ROE), and thus the appropriate rate of return (ROR). In addition to discussing

[1] Exh. 1 (Application).

[2] Exh. 45 (Motion for Settlement).

these two outstanding issues, DRA addresses the need for sanctions in light of CAW's long-repeated failure to properly serve the current and past GRC applications on certain parties.

CAW's proposed ISRS plan would be initiate a broad-scale infrastructure replacement program funded by a special ratepayer surcharge. CAW asks that it be allowed to make infrastructure improvements without prior Commission authorization, and proposes to seek cost recovery through an increasing surcharge (capped at a maximum rate increase of 10% over three years) that will only compensate CAW for completed projects. CAW proposes that DRA's and the Commission's review of the prudency of these ISRS expenditures occur after-the-fact, in a subsequent rate case. DRA strongly urges the Commission to reject the proposed ISRS because its effectiveness is questionable, its potential dangers are many, and in the absence of a long-term and comprehensive strategy for infrastructure replacement, it is a premature proposal.

With regard to the appropriate ROE for CAW, DRA recommends that the Commission adopt an ROE of 9.69% % based on the existing rate structure. CAW has also proposed a new rate structure, accompanied by a Water Revenue Adjustment Mechanism (WRAM) and a full-cost balancing account (FCBA), that will be addressed in a second phase of this proceeding. In the event that the Commission approves the requested WRAM and FCBA, DRA recommends an ROE decrease of between 156 and 328 basis points, resulting in an ROE between 7.97% and 6.41%.

Finally, DRA recommends that CAW be fined $110,000 for its persistent failure to properly notice cities within its service territory contrary to Rule 24 of the Commission's Rules.

II. ISRS

A. Introduction

DRA urges the Commission to reject CAW's request for an ISRS at this time. The ostensible purpose of the ISRS is to systematically replace its "aging" infrastructure in

the LA District. While DRA supports the goal of adopting regulatory mechanisms that ensure the ongoing viability of CAW's water systems, the proposed ISRS is merely one possible ratemaking tool, the need for which CAW has failed to demonstrate at this time.

To ensure that CAW properly invests in its infrastructure in a manner that prevents rate shock and/or massive system failures, DRA recommends that the Commission defer adopting ISRS as a ratemaking mechanism at this time. Instead, the Commission should require the utility to submit in its next rate case a detailed and comprehensive plan for necessary system upgrades and infrastructure replacement. As discussed in greater detail below, despite CAW's request for an ISRS and its apparent interest in acting quickly on this issue, such an infrastructure replacement plan does not yet exist. Not only is an ISRS an inappropriate vehicle for resolving these issues, an ISRS without an accompanying comprehensive plan opens ratepayers up to unnecessary risk.

CAW cites the Water Action Plan, (WAP) in which the Commission indicates the need for exploring an ISRS or Distribution System Improvement Charge (DSIC) to address the problem of aging infrastructure.[3] An ISRS or DSIC can vary in its details, however, and should be considered in a specific context. As discussed below, the benefits of this proposed ISRS for the company are considerable, but these benefits appear to come at the price of unnecessary risks and possible excess costs being imposed on CAW's ratepayers. In effect, the proposed ISRS: eases the utility's burden in rate cases; gives the utility overly broad discretion; allows the utility to increase rates up to 10% virtually unfettered; decreases the incentive of the utility to trim costs on ISRS projects, and; increases the likelihood that costs that DRA and the Commission would normally disallow will be allowed through the surcharge.

[3] Exh. 13 (Rebuttal/Stephenson) at 21.

B. CAW's Claimed Benefits of an ISRS

1. Need for a dedicated revenue stream

One of the reasons that CAW has proposed an ISRS is "[t]he need for a dedicated revenue stream to be exclusively used to offset a portion of the fixed costs of capital additions made to replace existing facilities.[4] CAW claims that a "dedicated revenue stream" will improve the company's internal "financial planning" processes in several ways.

> When an ISRS is finalized, financial plans for the allocation of funds for capital expenditures to replace existing infrastructure facilities will also identify associated ISRS surcharge revenue streams. As a result, all revenue calculations will be more accurate and predictable.
>
> As a result of improved revenue forecasting, better estimates of funds available to offset a portion of additional fixed costs of capital additions to replace existing facilities can be determined. The ability to add this level of precision to the financial planning process as a result of implementing ISRS will enable California American Water to improve its entire decision-making process for the allocation of funds for all capital improvement programs.[5]

It is unclear how the ISRS process will provide more "accurate and predictable" revenue calculations compared to traditional ratemaking. An ISRS is unlikely to affect other potential variations due to weather, consumption, etc. It is just a different way of collecting from customers. The ISRS surcharge is merely a percentage, separate from rates, that will vary throughout the three years of a rate case cycle, and possibly as often as on a quarterly basis, according to the ISRS projects that CAW actually completes.

Under traditional ratemaking, ISRS-like projects are counted in rate base, and the Commission adopts base rates to create a "revenue stream" that accounts for ISRS-type projects, non-ISRS-type projects, and many other things. Thus, under traditional

[4] Exh. 7 (Direct/Stephenson) at 24.

[5] Exh. 7 (Direct/Stephenson) at 26.

ratemaking CAW will know what its base rates will be for the next three years. However with an ISRS, CAW has a less predictable revenue stream because it can only speculate as to when it will complete projects, and completion of projects is what would trigger the first ISRS surcharge, and subsequent increases to that surcharge.

2. Ensuring customers that infrastructure is being replaced

CAW argues that a separate surcharge for infrastructure replacement projects is needed to assure customers that such replacement is being undertaken.[6] This appears to be a "solution" in search of a problem. Despite citing customer concerns as a reason for an ISRS, CAW has not demonstrated that customers in fact have significant concerns about the general state of their water systems, that they must be reassured of ongoing infrastructure replacement, or that a separate surcharge would in fact reassure them. Similarly, customers attending the Public Participation Hearings (PPHs) did not seem to give the proposed ISRS special attention or indicate that it would resolve any concerns.

3. Impact of the reduction in per-customer sales

Testimony of CAW Witness Stephenson indicates that one consideration for why CAW is seeking an ISRS is the " impact of a reduction in per-customer sales as related to funding a portion of the fixed cost of capital projects to replace existing facilities."[7] As a logical matter, there is no reason that reduced consumption will impact funding for ISRS-type projects any more than funding for other capital projects. It is unclear why this should be a special consideration in favor of an ISRS. Furthermore, as discussed below, CAW has also proposed a Water Revenue Adjustment Mechanism (WRAM) that would purportedly capture future reductions in sales.[8]

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[6] One reason for an ISRS is "[t]he need for alternative regulation to ensure customers that a portion of their monthly bills are used to fund specific capital projects to replace existing facilities." Exh. 7 (Direct/Stephenson) at 25.

[7] Exh. 7 (Direct/Stephenson) at 25.

[8] *See* Section III, below.

C. An ISRS Is Not An Antidote To Aging Infrastructure

An “ISRS” or a "DCIS” seems to have misleadingly become synonymous with a kind of “cure-all” for the water utility’s aging infrastructure problem. In justifying an ISRS, CAW states that “unless we start now on a replacement program for the many, many miles of pipe and services in our system, a failure could result as much of the systems age to or beyond the useful life of the infrastructure.”[9]

CAW explains why water systems must have a plan for replacements that may not meet the criteria that DRA have used in the past, such as “a large number of leaks, insufficient flow or timing with a government project.”[10] Instead:

> Proactive replacement has to be allowed. To wait for all plant to fail, or to be near failure is a disaster waiting to happen. Most water systems were built in a short time frame. The life expectancy of this infrastructure is all about the same. If you wait for the ultimate last minute to replace all of this infrastructure, you would be replacing a majority of water systems over a short period. This would cause significant rate shock, if a company could even afford to make the replacements. You have to spread replacements over a much longer timeframe than just that which depends on ultimate need or failure.[11]

CAW seems to suggest that an ISRS must be adopted in order to allow the company to engage in the necessary infrastructure upgrades. But CAW has not shown that the existing ratemaking structure has been the limiting factor. For example, CAW Witness Feizollahi responded as follows to questions about how getting an ISRS would change CAW’s infrastructure investment:

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26         Q   I think my question, though, is it appears,
27   under the existing ratemaking treatment you are able to
28   do all the projects you deem necessary?
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[9] Exh. 13 (Rebuttal/Stephenson) at 25.
[10] Exh. 13 (Rebuttal/Stephenson) at 26.
[11] Exh.13 (Rebuttal/Stephenson) at 25.

A Yes, your Honor.

Q So I don't see how you're going to be more aggressive.

You are getting the funding for all the projects you've found to be necessary.

A Your Honor, it's true. In my judgment, this ISRS program may have been misunderstood.[12]

In addition, it appears that CAW develops priorities for projects, and whether they are approved explicitly through traditional ratemaking or whether an ISRS is granted, CAW is likely to do the same set of high-priority projects.[13] Essentially, CAW has not identified why it could not undertake the necessary replacements under traditional ratemaking, and thus undermines the purported value of its proposed ISRS.

D. Any "Benefits" To Customers Are Outweighed By The Risks Caused By An ISRS

CAW also points to components of its proposed ISRS that will benefit or safeguard ratepayers such as a reduction in base rates[14] and a 10% cap on surcharges over three years.[15] These arguments are flawed. First, it is disingenuous to emphasize that an ISRS will reduce base rates. While factually true, it is a virtually meaningless argument from a ratepayer's point of view. A customer's bill may appear more palatable at the beginning of a rate case cycle if base rates do not reflect upcoming ISRS projects. Right after the first quarter, however, the customer's bill will begin to reflect an erratic,

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[12] 5 RT 331-332.

[13] *See, e.g.,* 5 RT 351.

[14] *See* 7 RT 523-524. Leading up to questions about ISRS costs being removed from a customer's bill for recovery through a surcharge, CAW asks DRA Witness Steingass: "Would you agree that customers would benefit from something that would result in a lower increase, something like a lower revenue requirement?" 7 RT 523:13-20.

[15] *See* Exh.13 (Rebuttal/Stephenson) at 22, lines 21-23.

yet ever increasing, surcharge. The predictability and reliability of overhead expenses that businesses crave is also applicable to the personal household expenses of residential ratepayers; as energy and other costs escalate, the more important predictability becomes.

Second, CAW commits to seeking an ISRS surcharge that, over the next three years, will not result in a rate increase greater than be 10% (10% cap). If an ISRS is adopted, a surcharge cap would be crucial. However, the cap proposed by CAW would act as less of a "safeguard" than it may appear. As pointed out in the evidentiary hearings, if recovered through surcharges, all of the ISRS projects under consideration in this proceeding would add up to much less than the 10% cap. Based on the approximations made during hearings, if CAW completed the projects that it has identified, prioritized, and justified as ISRS projects, ISRS surcharges would only result in a surcharge cap of about 7%.[16] The 10% "safeguard," therefore, gives CAW the flexibility to actually incur and seek recovery for an additional surcharge amount of roughly 3%. As discussed in Section II.G, below, DRA strongly urges that the appropriate cap for an ISRS in this case would be approximately 7%, rather than 10%.

Not only are the claimed benefits of an ISRS unconvincing, but an ISRS raises significant risks. CAW proposes that neither DRA nor the Commission review the reasonableness of ISRS projects until the next GRC, after they have already been completed.[17] Under CAW's approach, the company would begin recovering its investments on the ISRS projects as soon as they are finished, thus allowing their capital costs to be added into ratebase.

CAW emphasizes that DRA and the Commission retain their full authority to engage in a prudency review, merely that it is done after the fact. CAW offers somewhat unlikely remedies if DRA believes that some ISRS costs were imprudent. First, the

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[16] *See* 6 RT 450-454. CAW Witness Harrison concludes the discussion of the ISRS-type projects that would be removed from ratebase by stating that "in the end result we are pulling out the equivalent of fixed costs that are around 7 percent or equivalent to a rate increase of 7 percent." 6 RT 454:10-12.

[17] *See, e.g.,* Exh. 13 (Rebuttal/Stephenson) at 23-24.

Commission could remove the costs from ratebase.[18] This does not account for the monies that ratepayers have already been paid through the ISRS surcharge as soon as the project involving the imprudent costs was completed. Furthermore, DRA Witness Steingass observes that the Commission would be unlikely to make such a disallowance, in her opinion, as a political matter.[19] Second, CAW indicates that the Commission could decrease the company's ROE.[20] Such a severe penalty renders this "remedy" for imprudent costs even more unlikely than mere disallowance of the costs, and merits the skepticism expressed by Ms. Steingass.

E. Consideration Of An ISRS Is Premature

CAW acknowledges the experimental nature of its proposed ISRS:

> The proposed ISRS is a sort of trial balloon. We have to start somewhere, and where better than with a system that will provide some consistency to the replacement needs, but which needs to be slowly accelerated so that replacements don't lag further.[21]

CAW anticipates that it will conduct another Comprehensive Planning Study that will cover the need for replacing infrastructure. CAW Witness Valladao describes the study:

> I envision [it]as being more of a master plan, a long-range identification of projects going forward, we would -- ... -- essentially [be] using a matrix analysis of identifying infrastructure and … measuring need for replacement of that infrastructure, looking at evaluating it for age, material condition, things of that nature, typical criteria you would use

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[18] 6 RT 413.

[19] In response to CAW's questions about the post-construction review of ISRS costs after an Advice Letter is filed and in the next GRC, DRA Witness Steingass stated: "in both cases [the reviews are] after the fact. And so it essentially becomes more like a rubber stamp of what's already been done. And politically I think the Commission would be less likely to disallow the funding because of their desire to make sure that company -- utility companies are kept solvent." 7 RT 555:6-11.

[20] 6 RT 413-414.

[21] Exh. 13 (Rebuttal/Stephenson) at 26.

> in determining how you would go about replacing or the need for replacing infrastructure.[22]

In fact, the study "is planned to be" for 2008,[23] which would enable CAW to file it in its 2009 rate case for the LA District.[24] If CAW wants the "flexibility" of an ISRS, the utility should at least have a reasoned, forward-looking plan, defensible before the Commission, for how it will use such "flexibility" in the public interest. Far from being an example of micro-management, this expectation is eminently reasonable in light of the Commission's role of overseeing a monopoly utility that proposes to begin a systematic, capital-intense overhaul of its infrastructure.

In fact, granting an ISRS may be counterproductive at this point. DRA notes that denying CAW its ISRS should not prevent CAW from engaging in this more thorough analysis.[25] As a pragmatic matter, however, granting an ISRS in this proceeding would significantly lessen the utility's incentive for preparing and justifying a comprehensive infrastructure replacement plan.

In sum, an ISRS is only one kind of ratemaking tool, and the ISRS proposed by CAW does not provide either the right incentives to CAW or the right assurances for the Commission and ratepayers. DRA therefore recommends that consideration of this particular "trial balloon" be delayed, and that other tools be considered to achieve the goals articulated by CAW. DRA discusses below some ideas for streamlining the regulatory approval process once a utility has a sound infrastructure replacement strategy.

F. Other ways to stimulate appropriate investment while facilitating Commission review

Commission should consider other ways to facilitate Commission review and encourage a utility to pursue efficient infrastructure replacement without relinquishing

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[22] 5 RT 280:4-17.

[23] 5 RT 286: 9-10.

[24] 5 RT 286: 13-16.

[25] 5 RT 281:13-19 (agreeing that the study will "be done regardless of whether or not ISRS is granted").

the regulatory oversight that is statutorily required. For example, after CAW develops a sound long-term infrastructure replacement strategy,
CAW could continue to identify and propose ISRS-like projects in its GRC application, but DRA could review the reasonableness of the projects using modified criteria geared more towards ensuring that the projects are consistent with CAW's long-term strategy.

In order to modify the criteria against which DRA reviews project to determine their reasonableness and prudency, however, it is important that an infrastructure replacement plan be thorough. There are many issues that would be valuable for a company to address in such a plan, including: delineating the age, condition, location, operating history, and risk associated with the parts of the distribution infrastructure needing replacement or rehabilitation; justifying the extent of infrastructure replacement or rehabilitation warranted; incorporating impacts addressed by water conservation savings; identifying the amount of replacement per year, and how long the replacements will continue to provide safe reliable service to customer; discussing the financing and recovery alternatives considered; describing the long-term financial investment required, and; providing an analysis of the rate impact to customers over the course of the long term project to replace or rehabilitate infrastructure.

Rather than creating a post-construction review process that would limit the Commission's regulatory oversight and decrease CAW's accountability, the Commission should addressing aging infrastructure issues in the context of existing regulatory structures. Preparing a thorough study that allows DRA to streamline its review of certain projects has the advantage of:

- Assuring the Commission and ratepayers that CAW is replacing aging infrastructure strategically and in a manner that treats all of its districts appropriately;
- Relieving CAW from having to develop detailed justifications for ISRS-type projects;
- Minimizing the projects that require close review by DRA and the Commission, and;

- Allowing for rates that are predictable in that cost recovery will be through base rates rather than variable surcharges, and;

DRA must emphasize an important caveat to these recommendations. DRA is not offering a checklist on how to obtain an ISRS with DRA's approval. Finding that a utility's comprehensive plan is consistent with the public interest does not suggest a particular ratemaking mechanism. It does not follow that a good plan should in sense be "rewarded" with an ISRS. According to CAW's own statements, there is a need for such a plan, and CAW's witness has stated that the necessary review will occur in its 2008, regardless of whether it gets an ISRS in this proceeding.26 Thus, if the Commission does not adopt an ISRS in this proceeding, the necessary investments will not be unduly delayed.

G. Changes To CAW's Proposed ISRS

If an ISRS adopted, the one proposed by CAW should be modified to adopt a cap of approximately 7% rather than the 10% cap proposed by CAW. In its application, CAW has provided its traditional form of justification for the specific projects that would fall under ISRS, if an ISRS is granted. CAW has thus developed specific capital improvement priorities for the next three years that, to the extent listed in the Settlement Agreement between the parties, appear to be reasonable to DRA. If an ISRS is granted for the next rate case period, it is reasonable to cap the surcharges based on CAW's planned ISRS projects. While there was some confusion during hearings, it appears that such a cap would be in the neighborhood of 7%.[27]

CAW has already spent the resources to identify, estimate the costs of, and justify the most important ISRS-type projects for the next three years. This would give CAW discretion to modify its priorities among its ISRS projects, up to an approximate 7% cap.

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[26] There is nothing to suggest that CAW will not go forward with developing a strategy for infrastructure replacement, but DRA notes that CAW should be held to this commitment.

[27] *See* 6 RT 450-454. CAW Witness Harrison concludes the discussion of the ISRS-type projects that would be removed from ratebase by stating that "in the end result we are pulling out the equivalent of fixed costs that are around 7 percent or equivalent to a rate increase of 7 percent." 6 RT 454:10-12.

While it does not give CAW the full flexibility of the requested 10% cap, CAW has neither demonstrated the need for a dramatic increase in "routine" replacements, nor developed a long-term strategy that would justify a 10% cap. In sum, if the Commission grants an ISRS, it is important that it at least allow only a cap of approximately 7%, rather than the 10% cap requested by CAW.

III. COST OF CAPITAL

DRA and CAW have settled all issues relating to the cost of capital except for return on equity (ROE). DRA recommends an ROE of 9.69%, while CAW requests an ROE of 11.0% for 2006-2009.

In the second phase of this proceeding, the Commission will be considering CAW's requests for a new rate structure that includes a water revenue adjustment mechanism (WRAM), and full-cost balancing accounts for purchased power and purchased water (FCBAs).[28] If either or both of these regulatory mechanisms is adopted by the Commission, the effect will be to substantially reduce CAW's already low risk profile. In the event that the Commission approves these requests in the second phase, DRA recommends that the utility's ROE be reduced by between 156 and 328 basis points which, based on DRA's recommended rate (9.69%), would result in an ROE between 7.97% and 6.41%. CAW denies that any change in its ROE is merited if its new rate design proposal is adopted.

The legal standard for setting the fair rate of return was established by the United States Supreme Court. In the Bluefield Water Works case, the Supreme Court stated that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and set forth criteria for setting a reasonable rate of return.[29] That return should be:

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[28] Exh. 37 (CoC Report/Hogland) at 3-2.

[29] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679, 692-693 (1923).

> ...reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[30]

As the Supreme Court noted in that case, however, a utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.[31] In 1944, the Supreme Court again considered the rate of return issue in the Hope Natural Gas Company case affirming the general principle that, in establishing a just and reasonable rate of return, consideration must be given to the interests of both consumers and investors.[32]

As discussed below, the ROE sought by CAW in this case is neither just nor reasonable. On the other hand, DRA's recommended ROEs are supported by the facts, the law, and the Commission's policies and practices, and should be adopted.

A. Return on Equity (without WRAM/FCBA impacts)

In general, a company's total risk is the combination of business risk and financial risk. Business risk refers to the uncertainty inherent in the projections of future operating income relating to the fundamental nature of the company's business. For regulated utilities, business risk consists primarily of regulatory risk. Financial risk relates to the amount of debt in the capital structure: the greater the ratio of debt to equity, the greater the financial risk.[33]

CAW's business risk is quite low. This Commission provides all water utilities with a multitude of mechanisms that minimize risk. These include balancing accounts for purchased water, purchased power, and pump taxes, memorandum accounts for catastrophic events, memorandum accounts for Safe Drinking Water Bond Act

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[30] *Id.*
[31] *Id.*
[32] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
[33] Exh. 37 (CoC Report/Hogland) at 3-1.

compliance, 50% fixed cost recovery, and provisions for the inclusion of construction work in progress expenses in rate base.[34] The Commission is only now beginning to address the fact that water utility ROEs do not necessarily reflect the reduction in risk inherent in these balancing and memorandum accounts. In D.05-07-022, the Commission stated that:

> …CWS is protected through separate balancing accounts for purchased water, purchased power and pump taxes, and memorandum accounts for catastrophic events and waste contamination. The result of these protections is to reduce the risk that CWS faces with regard to its opportunity to earn its return on equity. Consequently, we expect that in future proceedings all of these existing and adopted protections against erosion of future earnings will be given their proper weight in the determination of risk and consequently return on equity.[35]

A company's total risk (business risk plus financial risk) is indicative of its overall financial integrity and ability to attract capital. Standard & Poor's (S&P) rating agency, for example, evaluates a company's total risk in order to assign a credit rating, a direct measure of a company's ability to attract capital. Standard & Poor's evaluation includes a subjective analysis of business risk, including such things as managerial quality and regulatory environment, and a quantitative analysis, which uses financial ratios to measure how a company can generate earnings and cash-flow to meet its debt obligations.[36] A rating of "AAA" through "BBB" is considered "investment grade."

While S&P does not rate CAW, it does rate American Water Capital Corporation (the affiliate from which CAW issues debt), as well as RWE and Thames, the owners of American Water Works (CAW's parent company). These entities are rated A-, A+, and A, respectively. Without question, CAW currently has the ability to attract capital.[37]

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[34] Exh. 37 (CoC Report/Hogland) at 3-1.

[35] D.05-07-022, 2005 Cal. PUC LEXIS 286, *27 (Section VII.G).

[36] Exh. 37 (CoC Report/Hogland) at 3-3 – 3-4.

[37] Exh. 37 (CoC Report/Hogland) at 3-4.

DRA notes that, while RWE has announced plans to spin off its ownership of American Water Works through an initial public offering, DRA cannot determine what impact this will have on the overall company's debt rating.

CAW's low business risk and healthy financial ratios (based on S&P benchmarks) are indications of a well-managed company. CAW takes advantage of that low business risk by maintaining a higher ratio of long-term debt to total capital, which lowers the overall cost of capital and benefits ratepayers.

1. CAW's Proposed Leverage Adder Is Unnecessary and Has Not Been Justified

As discussed in Exhibit 37, DRA's Report on the Cost of Capital, CAW seeks a 270 basis point adder to its ROE to reflect what CAW alleges to be increased financial risk because it is more leveraged than its sample group of water utilities.[38]

CAW Witness Reiker describes his rationale for a "leverage adder:"

> My 10.4 percent market cost of equity estimate for the sample water utilities represents the return a typical investor requires for purchasing a share of stock in the average water utility, capitalized in terms of market value with approximately 33 percent debt and 67 percent equity. California American Water's regulatory capital structure has significantly more debt and reflects greater financial risk than that of the sample water utilities. Therefore, any estimate of the cost [of] equity which relies on market data for the sample water utilities must be adjusted to reflect the financial risk associated with California American Water's regulatory capital structure if it is to constitute a fair rate of return in this proceeding.[39]

Mr. Reiker goes on to describe his method for determining the "effect of debt on a company's cost of equity."[40] He calculates that "[o]n average, California American Water's cost of equity is approximately 270 basis points *higher* than the cost of equity to

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[38] Exh. 37 (CoC Report/Hogland) at 4-1 – 4-2; *see also* Exh. 4 (CoC Report/Reiker/CAW) at 36-37.
[39] Exh. 4 (Direct/Reiker) at 32.
[40] Exh. 4 (Direct/Reiker) at 37.

[CAW's] sample water utilities," and concludes that this is an appropriate "financial risk adjustment."[41]

DRA Witness Hogland declined to adjust the ROE and observes that:

> Consistent with DRA's position in recent years DRA believes the Commission should determine if Cal Am gets a premium based on its common equity ratio, not ratepayer advocates. It is Cal Am's choice to carry a lower common equity ratio and [to] do it without adverse affect to the company.[42]

In the past, DRA has considered an "ROE incentive" to compensate a water company for its "practice of maintaining a higher a ratio of long-term debt to total capital."[43] The Commission has observed in such a case that:

> Debt financing is less expensive for ratepayers than equity financing because debt interest is tax-deductible while common equity returns are not. The marginal cost of debt, however, also increases with increasing leverage, and the two effects tend to offset within a reasonable capital structure range.[44]

While DRA does not recommend a leverage adjustment in this proceeding, DRA acknowledges that there may be circumstances under which such an adjustment would be reasonable.[45] In response to a question by CAW, DRA Witness Hogland noted the value of considering the reasonableness of a proposed ROE adjustment by looking at previous Commission activity:

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26         Q   So if the Commission deems that a leverage
27   adjustment is reasonable, DRA supports that
28   recommendation?
 1         A   I think that DRA would have to look at it in
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[41] Exh. 4 (Direct/Reiker) at 37.
[42] Exh. 37 (CoC Report/Hogland) at 4-1.
[43] D.03-02-030, *mimeo*, at 61 (footnote omitted).
[44] D.03-02-030, *mimeo*, at 62, note 57.
[45] 7 RT 510: 6-8.

> some light, and look if the adder was somewhat comparable to what the Commission has previously determined was reasonable, or what the parties have in prior circumstances agreed was a reasonable adder.[46]

In this case, CAW's proposed leverage adjustment of 270 basis points is far beyond the range of the leverage adjustments considered in past Commission decisions. In a rate case for CAW's Monterey District, for example, DRA did propose an "ROE incentive" – in the form of an adder of only 22 basis points.[47] Furthermore, CAW supported DRA's proposed 22 point adjustment as an appropriate adder to CAW's calculated ROE, and did not propose an alternative adder.[48] In D.04-05-023, the Commission described the proposal of CAW's cost of capital to add "60 basis points to each of his ROE results to adjust for his belief that CalAm is more risky than the average water utility in the samples….[49] Along the same lines, the settlement that CAW and DRA reached for CAW's Coronado District states: "The Parties agree that 25 basis points must be removed from the 10.10% authorized in D.04-12-055 in order to recognize that recovery of any [*38] leverage adjustment for the former Citizens Districts is already included in the recovery of the acquisition premium."[50] In contrast to this range of adders, Mr. Hogland notes that CAW's proposed "270 point adder amounts to an additional 30% for the cost of equity."[51] CAW has not explained why the ROE adder in this case should differ so dramatically from previously considered leverage adjustments. Given the lack of justification or evidence supporting CAW's 270 basis points risk

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[46] 7 RT 500-501.

[47] D.03-02-030, *mimeo*, at 61.

[48] D.03-02-030, *mimeo*, at 66.

[49] D.04-05-023, *mimeo*, at 53 (rate case for CAW's Sacramento, Larkfield, and Felton Districts).

[50] D.04-12-055, 2004 Cal. PUC LEXIS 576, *37-38.

[51] Exh. 37 (CoC Report/Hogland) at 4-2.

adjustment, the Commission should reject CAW's request as unnecessary and wildly disproportionate to CAW's actual risk profile.

B. If The Commission Adopts Either A WRAM Or The FCBAs For CAW The Company's ROE Should Be Substantially Lower

The issue of whether CAW should be allowed a Water Revenue Adjustment Mechanism (WRAM) and Full Cost Balancing Account (FCBAs), in connection with its proposed inverted block structure rates, will be addressed in a second phase of this proceeding.[52] How adoption of these features should affect CAW's ROE remains in this phase of the proceeding, however. If the proposed WRAM and FCBAs are approved, DRA urges the Commission to reduce CAW's ROE by between 156 and 328 basis points which, based on DRA's recommended rate (9.69%), would result in an ROE between 7.97% and 6.41%.[53]

1. CAW's Requested WRAM

In Special Request # 2, CAW seeks a variance from the Commission's standard rate design ostensibly to implement a new rate structure that is intended to encourage conservation. Through the use of a WRAM, CAW's new rate proposal "requests assured recovery of 100% of the fixed costs:"[54]

> What we are proposing in this instance is that the company should be allowed to recover all of its fixed costs, as defined in D.85-06-064, through a monthly service charge and a quantity rate that is protected by a WRAM account. In essence, California American Water is requesting that all fixed costs be assured of recovery to the extent possible.[55]

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[52] *Assigned Commissioner's Scoping Memo and Ruling*, 5/22/06, at 9.

[53] For the purposes of the ensuing discussion, references to ROE assume the adoption of a WRAM and the FCBAs unless otherwise specified.

[54] Exh. 3 (Exh. A to Application), Chapter 13, Section 1, at 2 of 5.

[55] Exh. 7 (Direct/Stephenson) at 11.

CAW expands on the mechanics of the new rate design and the role of a WRAM, stating that:

> The proposed tariff is basically designed in exactly the same way that current tariffs are designed, except that instead of recovering only one-half of fixed cost in the monthly service charge, the monthly service charge essentially designed to recover 100% of the fixed costs. However, the service charge will really only…recover[] a portion of the amount in the fixed monthly fee, with the remainder to be recovered in a quantity rate. A WRAM account is then used to track the difference between what would have been recovered had all of the fixed costs been recovered in the monthly service charge and the amount actually collected in the monthly service charge and in the fixed-cost recovery quantity rate. The difference, whether over or under collected, will be tracked in a WRAM account for later recovery.[56]

As discussed below, CAW specifically proposes the WRAM, in conjunction with FCBAs, in order to lower the company's financial risk. Considered objectively, what CAW is actually proposing is to essentially eliminate any possibility of risk that it will not recover its fixed costs through its rates – "guaranteed" returns of this nature are rare in the American economy; CAW's ROE should be substantially lowered if the Commission deigns to essentially eliminate all risk for recovery of CAW's fixed expenses.

2. CAW's Requested FCBAs

Currently, CAW's balancing accounts for purchased power and purchased water make shareholders whole for changes in rate for purchased power and water. CAW's Special Request #5, its request for "full-cost" treatment of these balancing accounts, would also make shareholders whole for changes in those costs due to changes in the amounts of power and water actually purchased. CAW explains Special Request # 5 as follows:

[56] Exh. 7 (Direct/Stephenson) at 12.

> [CAW] is requesting that California American Water be authorized to maintain full-cost purchased water and power memorandum accounts that track the entire variance between the costs adopted as part of a decision in this case and the costs actually incurred by the Company.[57]

CAW Witness Stephenson puts it more simply in his Further Testimony on WRAM issues: "[t]he main thrust of this request [is] that if revenues do decrease because of conservation, then the cost of water and power will also go down."[58] One of CAW's arguments for the FCBAs is that "[c]ustomers and the Company should only pay for and recover actual costs incurred – not costs projected in a rate proceeding that could change for a variety of controlled and uncontrollable reasons." This aspect of FCBAs is directly relevant to the appropriate ROE for the utility, as discussed below.

3. Because WRAM And FCBAs Lower CAW's Risk Profile, the Commission Should Lower its ROE if Either or Both of These Mechanisms Are Adopted

Many industries face the same type of risks that water utilities face without either a WRAM or FCBAs. Competitive markets in the retail sales, travel, and construction industries, for example, face revenue risks beyond their control such as adverse weather conditions, seasonal consumption, and changes in market demographics. As companies in these competitive industries generally have such risks reflected in their stock performances, regulated water utilities should have these risks, *or the lack thereof*, reflected in their rates of return.

Failure to reduce the rate of return to account for elimination of normal business risk would allow CAW to earn a return that reflects normal revenue risk without facing exposure to actual risk. This is neither acceptable, nor legal, as the Commission is required to ensure that rates are just and reasonable. As Public Utilities (PU) Code § 451 states:

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[57] Exh. 7 (Direct/Stephenson) at 34.

[58] Exh. 48 (Further WRAM/Stephenson) at 4.

> All charges demanded or received by any utility…shall be just and reasonable. Every unjust or unreasonable charge demanded or received for such product or commodity or service is unlawful.

An extensive body of Commission decisions discusses the nexus between risk and rate of return. In D.86-05-064, for example, the Commission rejected a Sales Adjustment Mechanism (SAM).[59] The Commission rejected the SAM based, in part, on the unfair balance between the reduced risk and the increased burden on ratepayers. The Commission stated, ""[a]lthough such a goal [100% fixed cost recovery] would substantially reduce a utility's financial risk…it would substantially burden the average residential customer."[60] In the case at hand, the Commission has the opportunity to mitigate the ratepayer burden by reducing CAW's ROE.

Furthermore, in D.05-07-044, a recent GRC decision for San Gabriel Valley Water Company, San Gabriel requested a full cost balancing account.[61] While rejecting this proposal, the Commission acknowledged the nexus between risk and rate of return:

> The parties gave no indication how their agreed rate of return should be adjusted should the Commission change San Gabriel's risk profile and increase its potential for profit by granting it full cost balancing accounts that others do not enjoy.
>
> We conclude that full cost balancing accounts for San Gabriel's LA Division are not in the public interest and should not be authorized.[62]

Thus, a reduction in risk should be reflected in the utility's rate of return through a reduction in ROE or ratepayers will be exposed to the prospect of over-compensating a company's shareholders for returns not equal to its risks.

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[59] *See* D.86-05-064, 1986 Cal. PUC LEXIS 972, *10-11 ((May 28, 1986).

[60] *See id.* at *11 (emphasis added).

[61] D.05-07-044, 2005 Cal. PUC LEXIS 295, *67 (July 21, 2005).

[62] *Id.* at *70-71.

CAW itself states that it is seeking a WRAM and FCBAs to limit the company's financial risk:

> As part of increasing its financial risk by exposing more of the recovery of costs to the up and down cycle of water sales, California American Water requests authority to track any such sales/revenue variances in a WRAM account. As will be discussed in greater depth in Special Request #5, California American also requests authority to track variances in the variable cost of purchased water and power by using Full Cost Balancing Accounts. If the requested tracking proposals are approved, the long-term exposure to increased financial risk of promoting conservation will be reduced.[63]

Regarding this issue, DRA's witness sagely observes, however, that granting these requests "would significantly reduce its normal business risk, as well as its regulatory risk."[64]

> In the event that Cal Am is allowed to implement a WRAM it would significantly reduce nearly all normal revenue risk. Removing all normal business risks to revenue would in effect turn its equity shares into risk free bonds….Accordingly DRA recommends that the Commission adjust Cal Am's authorized rate of return on equity, decreasing it be 328 basis points. DRA derived this adjustment by taking the spread between Cal Am's long term debt (6.41%), and DRA's proposed cost of Cal Am's equity (9.69%).[65]

Currently, a portion of fixed costs is recovered in a fixed customer charge. The balance of CAW's fixed costs is recovered in volumetric rates and is subject to sales fluctuations. CAW states that it "is proposing to be protected against changes in the recovery of authorized fixed costs based on the decision levels."[66] Combined with the

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[63] Exh. 3 (Exh. A to Application), Chapter 13, Section 1, at 2 of 5.

[64] Exh. 37 (COC/Hogland) at 3-2.

[65] Exh. 37 (COC/Hogland) at 3-2.

[66] Exh. 48 (Further WRAM/Stephenson) at 3.

FCBAs, CAW proposes to assure recovery of the revenue adopted by the Commission. In describing Special Request # 5 for FCBAs, CAW indicates that:

> Approval of [a WRAM] would result in the tracking of one portion of volumetric rates and approval of this request [for FCBAs] will result in the tracking of the other portion of volumetric rates.[67]

The full tracking of volumetric rates essentially amounts to removal of the risk that revenue will vary from adopted quantities, and as noted above, "[r]emoving all normal business risks to revenue would in effect turn its equity shares into risk free bonds."[68] With a WRAM and FCBAs that track and recover volumetric revenue, CAW's return should be between that of a bond and that of utility with no WRAM or FCBAs.

DRA arrived at its minimum recommended reduction in ROE of 156 basis points by examining the effect of WRAM on revenue variation, as described in DRA Witness Hogland's Supplement to his COC testimony:

> Without WRAM…[CAW's] sales would deviate much more widely from the mean. Assuming revenues are distributed normally around the mean, i.e. in a "bell shaped curve," then approximately 99.7% of revenue will fall within 3 standard deviations of the mean if there is no WRAM and no FCBA as proposed by Cal Am for its LA District. This is a wide deviation which is comparable to the range of sales itself. Cal Am furnished the mean and standard deviation of its sales per customer as outputs from its EViews forecasts. On the average, for residential and commercial customers for each of the LA District's three sub-districts, three standard deviations from the mean is about twenty times larger than five percent of the mean. This means that WRAM plus FCBA reduce revenue variation by about 95%. Based on Cal Am's EViews regressions of sales per customer,

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[67] Exh. 3 (Exh. A to Application), Chapter 13, Section 1, at 4 of 5. DRA notes that CAW's actual statement is that "[a]pproval of Special Request #3 would result in the tracking of one portion of volumetric rates…." (emphasis added). It is DRA's judgment that this statement only makes sense if CAW intended to reference Special Request #2. Special Request #3 relates primarily to the Full Integration of Tariffs such that "the final monthly meter charge and volumetric rates [are made to] be the same for all customers of the Los Angeles District." *Id.* at 3 of 5. As CAW states in discussing Special Request #3, "Special Request #2 will result in volume prices that …recover costs…," which is directly relevant to the substance of the quote above.

[68] Exh. 37 (COC/Hogland) at 3-2.

> WRAM and FCBA effectively narrow the distribution of collected revenues around the mean from three standard deviations to five percent of the mean, which is a reduction of approximately 95%. This narrowing of the distribution of the revenues collected drives the reduction in risk. DRA estimates that this 95% narrowing of the distribution of revenue accounts for about 95% of the risk attributable to revenues that is captured in the ROE.
>
> Since the cost of long-term debt reflects the utility's capital risk, the difference between the utility's cost of long-term debt and its ROE reflects the utility's business risk. In this case that is 328 basis points based on DRA's recommended cost of long-term debt and recommended ROE. If one then assumes that revenue and expense recovery each represent half of the business risk identified, and that Cal Am's proposed WRAM and FCBA combine to assure recovery of revenue, as Cal Am states it does, then the business risk associated with revenue recovery is 164 basis points. Since DRA estimates that WRAM would eliminate 95% of the risk associated with revenue recovery, this would result in a recommended reduction of 156 basis points.[69]

Furthermore, underlying this analysis was the assumption, apparently mistaken, that CAW would be allowed to amortize its WRAM balancing account when there was an over- or under-collection that exceeded 5% of adopted sales:

> This means that the maximum deviation of sales from the mean carried in the WRAM balancing account is likely to be five percent, and that 100% of sales revenue will be recovered within five percent of the mean.[70] Any greater deviation would cause the utility to seek amortization of the WRAM balance.

However, CAW points out that all shortfalls in their WRAM account will be recovered, and not just the shortfalls in excess of 5% of the adopted revenues.[71] Without this limiting feature of 5% in the WRAM in this proceeding, it appears that there will be a greater reduction in revenue volatility than assumed by DRA, and thus a greater reduction

[69] Exh. 50 (Supplement/Hogland) at 6-7.

[70] Theoretically the two year maximum deviation of sales from the mean could be five percent by having sales be 5% low one year and then 10% high the next, for a combined deviation of 5% in the WRAM account.

[71] Exh. 48 (Further WRAM/Stephenson) at 8.

in the risk assumed by DRA when it performed the above analysis. Thus, DRA's recommendation of a minimum reduction of 156 basis points is conservative.

In conclusion, with the adoption of a WRAM and FCBAs, the removal of revenue risk will cause CAW's securities to resemble bonds in their risk profile, and CAW's ROE should reflect these effects. Otherwise, allowing CAW's ROE to remain unchanged will result in an over-collection from ratepayers and a possible illegal increase in rates.[72] Moreover, in considering the merits of a WRAM and FCBAs in the instant case, the Commission should be mindful that if CAW's revenues are largely guaranteed by Commission action, it will have a diminished incentive to operate efficiently and minimize its expenses.

4. The Monterey WRAM

For CAW's Monterey District, the Commission has authorized a WRAM without an adjustment in ROE. The Monterey WRAM, however, is very different from the one under consideration above . The Monterey WRAM does not reduce the level of risk in a way that is comparable to the reduction in risk that would result from the instant WRAM. The Monterey WRAM is only intended to capture revenue shifts that are caused by an inverted-block-rates (IBR) rate design, and does not capture revenue shifts due to changes in consumption. As the Commission describes in D.96-12-005, the first decision approving a WRAM in the Monterey District:

> Cal-Am is authorized to…establish a Water Revenue Adjustment Mechanism to track the variations in revenue resulting from experimental rates.[73]

The second decision approving a WRAM in Monterey adopted a settlement agreement that is more explicit:

> Cal-Am and RRB [Ratepayer Representation Branch of the Commission's Water Division] agree that the Water Adjustment Mechanism Balancing Account should be

[72] *See* PU Code § 451.

[73] *Re California-American Water*, D.96-12-005 at OP 8 (Dec. 9, 1996).

> continued for the undercollection or overcollection of revenues due to the design of rates for the Monterey Division. RRB and Cal-Am agree that only differences caused by the design should accrue to the account and that differences caused by variations in consumption are not appropriately accrued to the account.[74]

These decisions make it clear that the revenue stream in CAW's Monterey District is still at risk for loss of sales due to weather, poor service, conservation, and other reasons. Unlike the WRAM proposed in this case, the Monterey WRAM does not guarantee the utility's revenue stream from virtually all risks, and thus does not merit a reduction in that district's ROE.

5. The WRAM Under Consideration For CWS

In A.05-08-006, California Water Service Company (CWS) has proposed a WRAM that is more similar to the one under consideration in this proceeding.[75] A recently released Proposed Decision (PD)[76] in that case describes CWS' proposal as follows:

> In its eight GRC applications, CalWater proposed to establish what it termed a Water Revenue Adjustment Mechanism (WRAM), essentially a total revenue balancing account that would virtually guarantee that the utility would always receive the GRC-estimated sales revenues for the districts to which the WRAM would apply. CalWater's stated purpose was to remove a disincentive to conservation. Under its current policy established in 1986, the Commission favors a water rate design consisting of service charges that recover up to 50% of the water utility's fixed costs and quantity rates that recover the remainder of the fixed costs and all

[74] *Re California-American Water*, D.00-03-053, 5 CPUC.3d 316, 373 (Mar. 16, 2000). The Commission's intent was reaffirmed in: Resolution W-4206 at OP 2; *Re California-American Water*, D.03-02-030, *mimeo*, at 65-66, and; *OIR on Balancing Accounts in the Water Industry*, D.04-05-037, 2004 Cal. PUC LEXIS 261**,** *4 (May 27, 2004).

[75] In a Stipulation between CWS and DRA, the parties agree to applying the agreed-upon WRAM proposal "to all other districts for which Cal Water seeks a sales-related RAM." *Joint Motion of CWS and DRA to Approve Stipulation Concerning the Water Revenue Adjustment Mechanism (WRAM) and a Stipulation Regarding Remaining Issues*, A.05-08-006 (March 9, 2006) at 3.

[76] *Proposed Decision of ALJ McVicar*, A.05-08-006 (mailed July 21, 2006) (CWS PD).

> variable costs.[77] By placing nearly one-half of the water utility's fixed cost recovery in service charges that are less subject to variation, the Commission was able to reduce the utility's revenue volatility (and thus risk) at little or no additional cost to its ratepayers. This approach leaves at least one-half of the utility's fixed costs (and all of the variable costs) to be recovered in the quantity charges, so the more water it sells above the GRC estimate, the greater its opportunity to recover or over-recover its fixed costs.[78]

While A.05-08-006 was initiated before this proceeding, and DRA argued that a WRAM should lower the utility's ROE, it appears unlikely that A.05-08-006 will address the substantive merits of the issue, however. In response to CWS' request for a WRAM, DRA and CWS entered into negotiations and ultimately submitted a stipulation proposing inverted block conservation rates in conjunction with a WRAM.[79] The July 21, 2006 PD, however, would reject the joint stipulation because it "does not provide the Commission with sufficient information to discharge its regulatory obligations, and because it cannot be incorporated into this proceeding without undue delaying the proceeding or denying other parties due process."[80]

In rejecting the proposed stipulation, the PD highlights the importance of fully considering how the stipulation impacts CWS' return on equity. The PD identifies the likelihood that a WRAM, a type of balancing account, will increase risks to ratepayers:

> A balancing account that relieves the company of a risk of variability in its revenues and/or expenses does so by shifting that risk to ratepayers. That is, without a balancing account, the utility is at risk for variations while customers can look forward to paying known amounts for the water service

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[77] Footnote of CWS PD: "Decision (D.) 86-05-065 (May 28, 1986) in Order Instituting Investigation 84-11-041, Order Instituting Investigation (Rulemaking) into Water Rate Design Policy. Under the Commission's Water Action Plan (December 15, 2005), the Commission will encourage alternative rate designs, including increasing block rate designs, where feasible to promote conservation and after considering their effects on low-income customers.)." CWS PD, note 14, at 15.

[78] CWS PD at 14-15.

[79] As the CWS PD describes, the stipulation would "implement[] increasing-block rate structures…and a revenue adjustment mechanism to offset any variations in revenues and variable expenses such a rate structure might produce." CWS PD at 14.

[80] CWS PD at 20.

> they receive. Once a balancing account is introduced, customers assume some of that risk from the company.[81]

The PD concludes that one of the reasons that the WRAM stipulation should be rejected is that "[t]he effect on the rate return clearly should be examined, as we have noted in the past, but no party has attempted to do so in this record."[82] While the issue of whether a WRAM merits an ROE adjustment is moot under the PD's rejection of the proposed WRAM, it is evident that the ALJ in that proceeding considered the issue to be valid and important enough to put parties on notice that future cases involving a potential WRAM should include a thorough analysis of ROE impacts.[83]

6. RAMs in the Energy Industry

In response to DRA's recommendation to reduce CAW's ROE if a WRAM is adopted, CAW states that:

> [DRA] does not provide any evidence that it has been Commission policy or practice to adjust the rate of return when implementing revenue decoupling mechanisms (such as the Energy Revenue Adjustment Mechanism or ERAM) for energy utilities.[84]

CAW goes on to describe other states in which the risk of decoupling was recognized, but did not result in a change to the rate of return.[85]

DRA notes that the water industry and the energy industry have very different risk profiles. An electric utility now faces not just sales variability, but loss of market share. Thus, even when an energy utility reduces the risks related to individual customer behavior through an ERAM, the utility still faces the significant risk of losing market share. Energy customers can now engage in distributed generation and economic bypass,

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[81] CWS PD at 18-19.

[82] CWS PD at 19 (footnote omitted).

[83] As a draft decision that has not yet been voted on by the full Commission, the CWS PD reflects the views of the ALJ in A.05-08-006, and not the views of the Commission itself.

[84] Exh. 47 (Rebuttal/Morse) at 2.

[85] Exh. 47 (Rebuttal/Morse) at 3-4.

and will soon be able to engage in community choice aggregation. Water customers, on the other hand, have no equivalent choices. In addition, to a much greater extent than for water companies, the potential market share losses faced by energy companies are driven by technologies and an economy that are constantly evolving. As a result, a WRAM reduces a larger percentage of business risk than an ERAM does.

DRA notes further that, while the Commission experimented somewhat on its own with revenue adjustment mechanisms for energy utilities, the current incarnation of the ERAM was in response to a legislative mandate in PU Code § 739.10:

> The Commission shall ensure that errors in estimates of demand elasticity or sales do not result in material over or undercollections of the electrical corporations.

In sum, energy utilities are sufficiently different from water utilities in ratemaking, risk profiles, and markets such that ERAMs do not provide a good analytical parallel for WRAMs when the Commission is considering the impact of these regulatory mechanisms on a utility's risk as reflected in its adopted ROE. While the Commission has not reduced an ROE due to an ERAM, neither does a reduction in sales risk for an energy utility have the same overall affect on the utility's business risk as a reduction in sales risk for a water company.

IV. CAW SHOULD BE FINED FOR RULE 24 NOTICE VIOLATIONS

DRA recommends that the Commission fine CAW for its persistent failure to provide notice of rate increases to cities within its service territory, contrary to Rule 24 of the Commission's Rules of Practice and Procedure. DRA estimates that an appropriate fine for this continued flagrant violation of Commission rules should be $110,000. We explain below how we calculated that amount.

A. Background

Within its Los Angeles District, CAW serves an unincorporated service area called Baldwin Hills. It appears that approximately 80-90 customers in Heights of Ladera, an

area within the City of Inglewood that is located adjacent to unincorporated Baldwin Hills, are being served by CAW's Baldwin Hills water system.[86]

Rule 24 of the Commission's Rules of Practice and Procedure (Rules) requires utilities seeking a rate increase to notify the affected cities and counties of its request. In particular, an applicant must:

> …within ten days after filing its application with the Commission, mail a notice to the following stating in general terms the proposed increases in rates or fares: (1) the State, by mailing to the Attorney General and the Department of General Services, when the State is a customer or subscriber whose rates or fares would be affected by the proposed increase; (2) each county, by mailing to the County Counsel (or District Attorney if the county has no County Counsel) and County Clerk, and each city, by mailing to the City Attorney and City Clerk, listed in the current Roster published by the Secretary of State within, from, to, or in which the proposed increase is to be made effective;…

CAW states that various rate case applications of Baldwin Hills, and subsequently of the Los Angeles District, were not properly served as follows:

- The 1985, 1988, and 1991 applications for Baldwin Hills were not served on the County of Los Angeles.
- The 1985, 1988, and 1991 applications for Baldwin Hills were served at a former mailing address for the City of Inglewood. (CAW indicates that none of these applications were returned by U.S. Mail as being undeliverable.)
- The 1994 application for Baldwin Hills and the 1997, 2000, and 2003 applications for Los Angeles District were not served on the City of Inglewood at any address.[87]

In addition, it is DRA's understanding that the 2006 application in this case was not served on the Inglewood.

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[86] *See* 2 RT 97 ("unincorporated Baldwin Hills"), 117 ("80-90 customers"); 3 RT 188 ("servicing Heights of Ladera").

[87] Exh. 51 at 2.

B. Appropriate Sanctions

In D.03-05-078, in which the Commission considered possible remedies for a water utility's failure to comply with Commission requirements for purchasing another utility, the Commission referenced an earlier decision that adopted additional enforcement rules for the affiliate transactions of energy utilities:[88] "Under *Re Standards of Conduct* (1998) D.98-12-075, we have discretion to consider the severity of the offense, the conduct of the utility and the totality of the circumstances in assessing a fine."[89] The enforcement rules adopted in D.98-12-075 consider the potential remedies for rule violations and contain a discussion that:

> …distills the principles that the Commission has historically relied upon in assessing fines and restates them in a manner that will form the analytical foundation for future decisions in which fines are assessed.[90]

D.98-12-075 then lays out the following principles for determining the appropriate remedy for violations of Commission rules: the severity of the offense, the conduct of the utility (including the utility's actions to prevent a violation, the utility's actions to detect a violation, and the utility's actions to disclose and rectify a violation), the financial resources of the utility, and the totality of the circumstances in furtherance of the public interest.[91] Below, DRA considers CAW's violations of Rule 24 in light of these principles.

1. The Rule 24 Violations Impinged on Parties' Due Process Rights

In D.98-12-075, the Commission identifies three general kinds of harm appropriate to consider in analyzing the severity of a company's violation: economic

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[88] *Re Suburban Water*, D.03-05-078, 2002 Cal. PUC LEXIS 938, *31-37 (May 22, 2003).

[89] D.03-05-078, 2002 Cal. PUC LEXIS 938, *36 (referring to *In Re Standards of Conduct*, D.98-12-075, 1998 Cal. PUC LEXIS 1016, 84 CPUC.2d 155 (December 17, 1998) ("*Re Standards of Conduct*")).

[90] D.98-12-075, App. A at Section VII.D.2; 84 CPUC.2d at 187-188.

[91] D.98-12-075, App. A at Section VII.D.2.b.

harm, physical harm, and harm to the regulatory process.[92] CAW's failure to properly notify the Inglewood and the LA County of GRC applications appears to most directly implicate harm to the regulatory process. No physical harm is alleged, and there does not appear to have been economic harm. D.98-12-075 states that "[e]conomic harm reflects the amount of expense which was imposed on the victims, as well as any unlawful benefits gained by the public utility."[93] Whether one considers the City of Inglewood or the customers of the Heights of Ladera to be the "victims" in this case, there is no suggestion that CAW's violations caused either to incur expenses.[94]

The Commission also observed in D.98-12-075 that:

> Many potential penalty cases before the Commission do not involve any harm to consumers but are instead violations of reporting or compliance requirements. In these cases, the harm may not be to consumers but rather to the integrity of the regulatory process.[95]

CAW's violations in this case fall squarely within this category. In this case, the harm to the regulatory process is irreparable. By failing to notify Inglewood and LA County of its applications, it is possible that CAW effectively denied them the opportunity to participate in its rate case proceedings. In the case of Inglewood, the city has made evident both its interest in participating and its concern about lost opportunities to participate. While the Inglewood could have been gaining experience in CAW rate cases over the past couple of decades in order to most effectively participate, the city is instead at the beginning of its learning curve in this proceeding.

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[92] D.98-12-075, App. A at Section VII.D.2.b.i.

[93] D.98-12-075, App. A at Section VII.D.2.b.i.

[94] One may also question the extent to which Inglewood's and LA County's participation in CAW's GRCs could have resulted in lower rates. In this respect, one could argue that CAW's violations may have indirectly increased ratepayer expenses, and that CAW therefore reaped "unlawful benefits" from its actions. This inquiry, however, is fundamentally based upon Inglewood's and LA County's roles in the regulatory process, and may be more appropriately considered in the context of "harm to the regulatory process."

[95] D.98-12-075, App. A at Section VII.D.2.b.i.

Furthermore, the denial of Inglewood's opportunity to participate over a period of more than 20 years may have particularly disadvantaged the Heights of Ladera residents because their numbers are so small in comparison to the total number of customers in the Baldwin Hills system, and indeed in CAW's entire LA District. CAW states that the individual customers in the Heights of Ladera received proper notice,[96] however their concerns as relayed by Inglewood's city council would naturally carry more weight with both CAW and the Commission than if relayed by the individuals themselves.

In sum, CAW's Rule 24 violations are severe offenses in terms of harm to the integrity of the regulatory process because the lack of notice impinges on the due process right of having the opportunity to participate as an interested party in Commission proceedings.

2. CAW's Actions To Prevent And Detect Its Violations Were Poor

For its 1985 Baldwin Hills application, CAW failed to serve notice of its application on LA County, and improperly served Inglewood at an old address.[97] CAW appears to have failed to update its service lists, and repeated the same violations for two subsequent applications.[98] Starting in 1994, CAW did not provide service of its applications to Inglewood at all.[99] DRA considers these Rule 24 violations with regard to CAW's actions in preventing the violations, detecting the violations, and disclosing and rectifying the violations.

a) CAW's Actions To Prevent A Rule 24 Violation

The Commission in D.98-12-075 observes that, "[p]rior to a violation occurring, prudent practice requires that all public utilities take reasonable steps to ensure

[96] 5 RT 301.
[97] Exh. 51 at 2.
[98] Exh. 51 at 2.
[99] Exh. 51 at 2.

compliance with Commission directives."[100] In this case, prudent practice would have been for CAW to ensure compliance with Rule 24 by determining, for each GRC application, the cities and counties affected by the application, and obtaining current addresses for those entities. In particular, Rule 24 specifies that utilities must use the addresses "listed in the current Roster published by the Secretary of State" for service of its applications on cities and counties. Available online, the 2006 edition of the "Roster" of the California Secretary of State contains a "Welcome Letter" describing the contents of the document:

> This Roster provides a comprehensive listing of government official contact information, as well as historical outlines of our constitutional offices and our state emblems. It includes California's federal, state, and county government officials, judicial officials, incorporated city and town officials, a listing of California's unincorporated areas, state agency information, and state officials for all of the United States.[101]

Thus, for the purposes of preventing a Rule 24 violation, as well as detecting and rectifying possible prior violations, CAW should have both reviewed the governmental entities in its service areas and consulted the California Roster. It is possible, although DRA considers it unlikely, that the California Roster contained incorrect information about the City of Inglewood's address during the years in which CAW used Inglewood's former address. More likely, CAW failed to consult the California Roster for any of the years 1985, 1988, and 1991. It is unclear, however, why Inglewood then dropped off CAW's service lists entirely starting in 1994. While inadvertent, it is evident that all of CAW's violations stem from the utility's consistent failure, over a period of more than 20 years, to prudently ensure compliance with Rule 24.

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[100] D.98-12-075, App. A at Section VII.D.2.b.ii(1).

[101] Letter from Bruce McPherson, California Secretary of State (April 2006), available at http://www.ss.ca.gov/archives/ca-roster/pdf/00a_letter.pdf (accessed July 28, 2006). The information available in the Roster for the City of Inglewood includes the following, among other things: **"City of Inglewood (County of Los Angeles); Address:** One Manchester Blvd, Inglewood, CA 90301; **Mail Address:** PO Box 6500, Inglewood, CA 90306; **Telephone:** (310) 412-5280." 2006 California Roster at 112, available at http://www.ss.ca.gov/archives/ca-roster/pdf/02c_city_town.pdf (accessed July 28, 2006).

b) CAW's Actions To Detect A Rule 24 Violation

The facts about CAW's violations have emerged slowly throughout this proceeding and were largely uncovered only after CAW was questioned repeatedly about them. The first indication of potential problems arose during a Public Participation Hearing (PPH) on April 6, 2006, in the City of Inglewood. A representative of Inglewood attended to indicate that no notice of CAW's Application or of the PPH itself had ever been provided to Inglewood's city council.[102] CAW believed at the time that the city had been properly served.[103] It is DRA's understanding that Inglewood became aware of this proceeding only because the PPH was scheduled at the city's premises.

In a PPH almost two months later, Councilwoman Judy Dunlap of the City of Inglewood asked CAW to respond in writing to questions about the service of prior applications on Inglewood, the eligibility of Heights of Ladera customers for refunds, and a proposal from CAW about how such customers could withdraw from CAW's service area.[104] As a result of these questions, CAW conducted additional research. In letter dated June 12, 2006, CAW indicated that it had not served the 1994, 1997, 2000, and 2003 applications on the City of Inglewood,[105] and that the records (of CAW's outside counsel) for prior years were destroyed in accordance with the firm's record retention policy.[106] At the evidentiary hearing on June 13, 2006, the ALJ continued to seek additional information and asked CAW to look at its history of service beginning from the "inception of [CAW's] water service to Heights of Ladera." In the absence of company files elsewhere, the ALJ suggested the Commission's Formal Files as a

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[102] 2 RT 117.

[103] 2 RT 118.

[104] 3 RT 188-189 (PPH on May 31, 2006 in Inglewood).

[105] Letter from Christine J. Hammond, Steefel, Levitt & Weiss, to The Honorable Judy Dunlap, City of Inglewood (June 12, 2006) ("Inglewood Letter").

[106] Inglewood Letter at note 1.

potential source of information.[107] CAW's response in the form of Exhibit 51 contained yet additional instances of Rule 24 violations.[108]

It appears that CAW performed its most thorough research in preparing Exhibit 51 because CAW not only addressed the service problems to Inglewood, but turned up problems with service to LA County.[109] It is unlikely that the extent of CAW's violations of Rule 24 would have been discovered without persistence from the City of Inglewood and the ALJ, suggesting that CAW should show greater initiative in investigating problems more thoroughly when the first sign of a violation appears.

c) CAW's Actions To Disclose And Rectify The Rule 24 Violations

As discussed above, CAW's actions to determine the extent of its non-compliance with Rule 24 were primarily driven by external forces (specific inquiries from Inglewood and the ALJ). Once violations were discovered, it does not appear that CAW delayed in disclosing the violations to the Commission. In this case, only the failure to serve Inglewood for this rate case could be rectified, and CAW did so.

3. CAW Has Significant Financial Resources

D.98-12-075 states that:

> Effective deterrence also requires that the Commission recognize the financial resources of the public utility in setting a fine which balances the need for deterrence **[*94]** with the constitutional limitations on excessive fines. Some California utilities are among the largest corporations in the United States and others are extremely modest, one-person operations.[110]

CAW is owned by American Water Works, a company that has water districts in several states, and is one of the largest water utilities regulated by the Commission.

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[107] 5 RT 300.

[108] Exhibit 51 at 2.

[109] Exhibit 51 at 2.

[110] D.98-12-075, App. A at Section VII.D.2.b.iii.

Taking into consideration the financial resources of CAW, a penalty that is on the higher end of the range of possible fines is therefore necessary for effective deterrence.

4. Considering The Totality Of The Circumstances, CAW Should Be Fined $10,000 Per Violation

CAW argues that its violations do not merit a remedy because its individual customers, including those in the Heights of Ladera, received notice.[111] DRA considers CAW's repeated failure to properly notify both the City of Inglewood and the County of Los Angeles, the first of which continued for over 20 years and second of which continued for almost 10 years, to harm the integrity of the regulatory process in that it denied those entities an opportunity to participate in rate cases of significant interest to their residents.

Further, CAW appears to be arguing that because it complied with one provision of Rule 24, it was not required to comply with another provision of the same rule. DRA is unaware of any approach to legal interpretation holding that various provisions of a rule are mutually exclusive, even if the rule contains no language which so states. Here, Rule 24 expressly states that the customers, the county, and the city *all* are to be notified of a proposed rate increase. Alternatively, CAW's argument could suggest that because it complied with one provision of the rule, it should not be penalized for failing to comply with all of the relevant sections of the rule. DRA does not know what theory of legal interpretation CAW is applying in its analysis. Rule 24 is plain as day, and CAW simply has failed to comply with its requirements for a number of years. A penalty certainly is in order.

[111] 5 RT 301-302.

PU Code § 2107 gives the Commission authority to impose a fine of between $500 and $20,000 for each violation of a Commission rule.[112] In chronological order, CAW's violations consist of a failure to serve the following applications on the specified entities:

- 1985 Baldwin Hills application – not served on the County of Los Angeles (LA), and only served at the former address of the City of Inglewood (Inglewood);
- 1988 Baldwin Hills application – not served on LA, and only served at former Inglewood address;
- 1991 Baldwin Hills application – not served on LA, and only served at former Inglewood address;
- 1994 Baldwin Hills application – not served on Inglewood;
- 1997 LA District application – not served on Inglewood;
- 2000 LA District application – not served on Inglewood;
- 2003 LA District application – not served on Inglewood, and;
- 2006 LA District application – not served on Inglewood.

Counting each failure of service as one violation, CAW therefore had 11 violations of Rule 24. While the lack of notice may have been inadvertent, resulting from what could be perceived as an administrative oversight, the result was a serious infringement on Inglewood's and LA County's due process rights in numerous rate cases. Inglewood and LA County cannot be made whole after the fact, rendering the harm to the regulatory process irreparable. In light of CAW's significant financial resources relative to other Class A water companies, DRA believes that effective deterrence requires a fine of $10,000 per violation, resulting in a total fine of $110,000.

V. CONCLUSION

For the reasons discussed above, DRA recommends that the Commission reject CAW's proposed Infrastructure System Replacement Surcharge (ISRS). The Commission should also reject CAW's proposed 270-basis-point leverage adder to

[112] PU Code § 2107 states: "Any public utility which violates or fails to comply with any provision of the Constitution of this state or of this part, or which fails or neglects to comply with any part or provision of any order, decision, decree, rule, direction, demand, or requirement of the commission, in a case in which a penalty has not otherwise been provided, is subject to a penalty of not less than five hundred dollars ($500), nor more than twenty thousand dollars ($20,000) for each offense."

CAW's ROE. If CAW's proposed WRAM and/or full cost balancing accounts for purchased water and power are approved, however, the Commission should adopt an ROE reduction in the range of 156 to 328 basis points, resulting in an ROE between 7.97% and 6.41%. Finally, a fine of $110,000 should be imposed for CAW's numerous violations of Rule 24.

Respectfully submitted,

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July 31, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **"OPENING BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES"** in **A.06-01-005** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on **July 31, 2006** at San Francisco, California.

/s/ MARTHA PEREZ
Martha Perez

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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